IN THE

Supreme Court of the United States

October Term, 1942.

No. 475

THE DETROIT EDISON COMPANY,
Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

EDWARD H. GREEN,
NORRIS DARRELL,
48 Wall Street,
New York, N. Y.

OSCAR C. HULL,
HARVEY A. FISCHER,
Dime Building,
Detroit, Michigan.

Attorneys for Petitioner.

SULLIVAN & CROMWELL,
48 Wall Street,
New York, N. Y.
Of Counsel.

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The above named petitioner prays that a writ of certiorari be issued to review the judgment (R. 53) of the United States Circuit Court of Appeals for the Sixth Circuit affirming the decision of the United States Board of Tax Appeals in the above entitled proceeding.

OPINIONS BELOW

The opinion of the Circuit Court of Appeals (R. 54-61) is not yet officially reported. The opinion of the Board of Tax Appeals (R. 42-47) is reported in 45 B. T. A. 358.

JURISDICTION

The judgment of the Circuit Court of Appeals sought to be reviewed was entered November 30, 1942. Jurisdiction to issue the writ requested is found in the provisions

of Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

STATUTE INVOLVED

The statute involved is the Revenue Act of 1936, Ch. 690, 49 Stat. 1648, the pertinent provisions of which are as follows:

"SEC. 23. DEDUCTIONS FROM GROSS INCOME.

"In computing net income there shall be allowed as deductions:

* * *

"(1) *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * *

* * *

"(*n*) *Basis for depreciation and depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114."

"SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

"(*a*) *Basis for depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b), for the purpose of determining the gain upon the sale or other disposition of such property."

"SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

"(*a*) *Basis (unadjusted) of property.*—The basis of property shall be the cost of such property; except that—

* * *

"(2) *Gifts after December 31, 1920.*—If the property was acquired by gift after December 31,

1920, the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift, except that for the purpose of determining loss the basis shall be the basis so determined or the fair market value of the property at the time of the gift, whichever is lower.

* * *

"(4) *Gift or transfer in trust before January 1, 1921.*—If the property was acquired by gift or transfer in trust on or before December 31, 1920, the basis shall be the fair market value of such property at the time of such acquisition.

* * *

"(8) *Property acquired by issuance of stock or as paid-in surplus.*—If the property was acquired after December 31, 1920, by a corporation—

* * *

(B) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, * * *.

* * *

"(b) *Adjusted basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

"(1) *General rule.*—Proper adjustment in respect of the property shall in all cases be made—

"(A) for expenditures, receipts, losses, or other items, properly chargeable to capital account, including taxes and other carrying charges on unimproved and unproductive real property, but no such adjustment shall be made

for taxes or other carrying charges for which deductions have been taken by the taxpayer in determining net income for the taxable year or prior taxable years;"

Treasury Regulations 94, promulgated under the Revenue Act of 1936, provide with respect to Section 113(a) (8) (B):

"Art. 113(a) (8)-1. Property acquired by a corporation after December 31, 1920.— * *

"In respect of property acquired by a corporation after December 31, 1920, from a shareholder as paid-in surplus, or from any person as a contribution to capital, the basis of the property in the hands of the corporation is the basis which the property would have had in the hands of the transferor if the transfer had not been made. * * *"

QUESTION PRESENTED

What is the basis for depreciation for Federal income tax purposes of depreciable business property that is constructed by an owner who receives a cash payment from a non-stockholder as a condition precedent to the construction and operation of such property? Is the depreciation basis (a) the actual cost of construction or (b) the cost of construction reduced on account of the payment received from the non-stockholder?

STATEMENT

Petitioner is a public utility corporation of New York, licensed to do business in Michigan, and is engaged in generating and selling electric energy in the City of Detroit and surrounding territory and operates under the jurisdiction of the Michigan Public Service Commission. (R. 20.)

Petitioner, in connection with the distribution and sale of electric energy, from time to time receives applications for extension of its transmission and/or distribution lines to places which, in petitioner's opinion, are situated too far from its existing lines to warrant the expenditure of the amounts necessary to make such extensions. In such cases petitioner, prior to the construction of the desired extensions, requires the applicants to pay to it sums representing the estimated cost per mile for construction of such extension, which is agreed to in writing. (R. 20.) The amount paid by each applicant, which never exceeds the actual cost of construction, is final as to such applicant regardless of the actual cost of construction, except that under his contract he may become entitled to a refund upon the happening of certain events. (R. 20-21.)

The agreement between the petitioner and each applicant is evidenced by one of five standard types of contract. (R. 20, 29-42.) Under contracts of the first four types, the applicant becomes entitled to receive during the first five years following completion of the extension a refund of a sum up to but not exceeding the amount of his payment, computed in accordance with the formula depending for its operation upon either (1) the number of additional customers who subscribe for service over the particular line extension or (2) the gross revenue received from such line extension. Under contracts of the fifth type, the applicant is entitled to no refund. Under petitioner's rules, filed with the Michigan Public Service Commission, and printed on the reverse side of each contract, the applicant is permitted to build the line extension himself, if he chooses, and then turn them over to petitioner.

Material and labor used in the construction of the line extensions are paid from the general working funds of the petitioner and it makes in its books of accounts entries identifying all work performed under the provisions of each respective contract. (R. 21.)

Upon completion of a line extension, petitioner in accordance with standard practice enters upon its books as a property item the cost of the line extension including labor and material and does not subtract from that sum the amount of the payment made by the applicant. (R. 21.)

The cash payments received from applicants are not earmarked in petitioner's accounts for the construction of line extensions, but the sums received become part of petitioner's free working capital and are carried in petitioner's accounts accordingly. (R. 21.)

Petitioner's accounting procedure is in accordance with the Uniform Classification of Accounts for Electric Utilities prescribed by the Michigan Public Service Commission. (R. 21-23.) This procedure is as follows: Upon receipt of a payment from an applicant, petitioner debits its cash account and credits one of the special liability accounts referred to below with the amount thereof. In the case of payments subject to possible refund, the payments are credited to a special liability account entitled "Customers Deposits for Line Extensions", classified under account No. 261 entitled "Miscellaneous Unadjusted Credits"; and upon the expiration of the period for refund any unrefunded balance is transferred from account No. 261 to special liability account No. 255 entitled "Contributions for Extensions". In the case of payments not subject to refund, the payments are credited in the first instance to account No. 255. Upon construction of a line extension

owned by it, petitioner credits its cash account and correspondingly debits its property account. Depreciation on the line extension is currently credited to depreciation reserve and debited to depreciation, which is an operating expense entering into profit and loss account. Upon retirement of a line extension, depreciation reserve is debited and the property account credited. No adjustment is made to special liability accounts Nos. 261 or 255 in connection with the construction, depreciation or retirement of a line extension.*

After completion of a line extension, petitioner is under a legal duty, at its own expense, to keep and maintain the line extension in good repair and working order, and to replace the same in whole or in part as and when necessary, so that service will at all times be available therefrom. (R. 25.)

During the years 1936 and 1937, applicants' payments in the amounts of $36,065.81 and $47,500.67, respectively, were received subject to no refund or became unrefundable by virtue of the expiration of the period for refund. Petitioner did not report these amounts as income and respondent did not attempt to subject them to Federal income tax.

In its returns for 1936 and 1937, petitioner claimed depreciation deductions at approved rates upon its line extensions at their cost of construction as shown by its books,

*The Court and the Board erroneously assumed that when the period for refund expires all remaining balances in these accounts are credited to Surplus. Transfers to Surplus were in fact made only in 1932, 1933 and 1934. (R. 24.) These transfers were approved by the Michigan Public Service Commission on the understanding that for rate making purposes the amounts transferred would be included in income for the years in which the payments were received. *Re The Detroit Edison Company*, 16 P. U. R. (N. S.) 59 (Michigan, 1936).

without any deduction for amounts paid by applicants. Respondent disallowed a portion of such deductions on the ground that the basis upon which such depreciation deductions is to be calculated is the amount expended in construction of the line extensions diminished by the total amount paid by applicants under contracts providing for no refunds, and by the mean between the beginning and end of each year of the unrefunded balances of amounts paid by applicants under contracts providing for refunds and with respect to which the period for refund had expired. (R. 25-26.) He used this formula irrespective of whether the particular line extensions in respect of which the payments were made were still in existence.

The amount of depreciation deductions in dispute is $40,273.11 for the year 1936 and $41,786.26 for the year 1937 (R. 26) and the amount of income tax liability in dispute for said years is $4,031.04 and $6,267.94, respectively. (R. 6.)

The Board of Tax Appeals sustained the respondent (R. 47), and on appeal the Circuit Court of Appeals for the Sixth Circuit affirmed (R. 53).

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that the funds utilized by petitioner in constructing its line extensions can be traced and that their source is material in determining the cost to petitioner and its basis for depreciation of the line extensions.

2. In holding that payments received by petitioner from prospective customers upon applications for construction of line extensions constituted "receipts" to be deducted

under Section 113(b)(1)(A) of the Revenue Act of 1936 in determining petitioner's cost and basis for depreciation of its line extensions; and in failing to hold that such payments, if their status was material, constituted contributions to capital within the meaning of Section 113(a)(8)(B), or gifts, or consideration received for obligations of equal value assumed, as would clearly have been the case if the line extensions had been built by the applicants and then turned over to petitioner.

3. In holding that capital contributions can be made only by shareholders, and in thus disregarding the express provision of Article 113(a)(8)-1 of Regulations 94 that property may be received by a corporation "from any person as a contribution to capital."

4. In holding that capital contributions cannot be made for a specific purpose.

5. In holding that petitioner's basis for depreciation and its depreciation deductions for 1936 and 1937 in respect of line extensions constructed and owned by it and used in its business should be reduced on account of payments made to it by prospective customers on applications for construction of line extensions.

6. In affirming the decision of the United States Board of Tax Appeals.

REASONS FOR GRANTING THE WRIT

1.

The Circuit Court of Appeals for the Sixth Circuit has decided an important Federal tax question in direct conflict with the decision of the Circuit Court of Appeals for the Fourth Circuit in *Arundel-Brooks Concrete Corpora-*

tion v. *Commissioner*, 129 F. (2d) 762. This is expressly pointed out in the opinion below, wherein the Court said (R. 61): "The conclusion here reached is in conflict with the case of *Arundel-Brooks Concrete Corporation* v. *Commissioner of Internal Revenue*, 129 F. (2d) 762 (C. C. A. 4), which is strongly relied on by petitioner."

In the latter case, Arundel-Brooks Concrete Corporation constructed for $40,000 a concrete mixing plant at Sparrows Point, Maryland, in order to supply Bethlehem Steel Company with concrete necessary for new construction. Maryland Slag Company contributed $20,000 toward the construction cost, it being in its interest to do so since it had a contract with Bethlehem Steel Company to remove, process and market slag from the latter's blast furnaces at Sparrows Point and processed slag was used in making concrete. The Commissioner claimed that Arundel-Brooks Concrete Corporation had a depreciation basis for the new plant of only $20,000 and the Board of Tax Appeals sustained him. The Circuit Court of Appeals for the Fourth Circuit reversed the Board and held that the corporation's basis for depreciation of the plant was the $40,000 actually expended in the building thereof and not that sum less the $20,000 contributed by Maryland Slag Company toward the cost of construction. The Court found it unnecessary to determine with legal exactness the precise nature of the $20,000 contribution (the briefs had not presented the question whether it was a contribution to capital), since " 'cost' * * * would remain the same regardless of the source of the funds from which payment was made."

In the present case, the Circuit Court of Appeals for the Sixth Circuit has held that the petitioner's basis for depreciation of its line extensions was not the amount

expended by it in their construction but was that amount less certain amounts contributed by prospective customers toward the cost of construction. The Court ruled that the contributions were not gifts because supported by considerations, that they were not contributions to capital or paid-in surplus because the contributions were not made by shareholders and were for the specific purpose of constructing improvements but that they constituted "receipts" which must be deducted under Section 113(b)(1)(A) of the statute in determining petitioner's cost.

In ruling that the contributions were supported by considerations and therefore did not constitute gifts, the decision is probably inconsistent with the decision of the Circuit Court of Appeals for the Seventh Circuit in *American Dental Company* v. *Commissioner*, 128 F. (2d) 254, certiorari granted October 12, 1942.

In ruling that the contributions were supported by considerations and failing to recognize the value of such considerations as their "cost", the decision is probably in conflict with the decision of the Circuit Court of Appeals for the Ninth Circuit in *Robinson* v. *Commissioner*, 97 F. (2d) 552, affirming 35 B. T. A. 1080. There the owner of a public utility entered into contracts, with the approval of the Railroad Commission of California, whereby he received from the subdividers of certain land title to water mains, pipes and other connections, to be installed by the subdividers or at their expense, in consideration for which he agreed to maintain the property so received and to furnish at regular rates an adequate supply of water to consumers in the subdivision. The basic question in the case was the cost of the property to the public utility owner; and both the Board and the Court held that the value of his

agreements, constituting his cost of the property, was the value of that property since it was given to him in return for his agreements in a transaction entered into between parties dealing at arm's length.

2.

The Circuit Court of Appeals has decided an important Federal tax question in a way probably in conflict with the views expressed by this Court in *Edwards* v. *Cuba Railroad Company*, 268 U. S. 628.

Edwards v. *Cuba Railroad Company* involved the taxability as income of money subsidies granted by the Cuban Government to a railroad company to promote construction of a railroad in Cuba and coincidentally to obtain reduced rates and other privileges. The subsidies were fixed and paid proportionately to mileage actually constructed and were used by the company for capital expenditures but were not used to reduce the actual cost of construction as carried on the books. In addition to the money subsidies the Cuban Government also contributed certain lands and other physical property in aid of completion of the railroad. The Treasury sought to tax the money but not the property. This Court, stating that the subsidies of neither kind were received as mere gratuities, held that they were not income and indicated that they were capital contributions, saying:

> "The subsidy payments were proportionate to mileage completed; and this indicates a purpose to reimburse plaintiff for capital expenditures. All—the physical properties and the money subsidies—were given for the same purposes. It cannot reasonably be held that one was contribution to capital assets, and that the other was profit, gain or income."

There, as here, the subsidies were received from non-stockholders and for the specific purpose of constructing property. Yet this Court considered them capital contributions.

There, this Court thought that contributions in money and physical properties for similar purposes should be treated alike. Here, if the line extensions themselves had been contributed to petitioner in lieu of cash as petitioner's rules permitted (R. 29-42), they obviously would not have constituted receipts serving to reduce the cost of any of petitioner's assets under Section 113(b)(1)(A). Yet the Circuit Court of Appeals would apparently distinguish between the treatment of cash and property contributions for the same purposes, since it has here applied Section 113(b)(1)(A) to the receipt of the cash.

3.

The Circuit Court of Appeals has decided an important Federal tax question in a way that is probably in conflict with decisions of this Court including *Helvering* v. *Wilshire Oil Co., Inc.*, 308 U. S. 90, and *Helvering* v. *R. J. Reynolds Tobacco Co.*, 306 U. S. 110.

These cases require that unambiguous Treasury Regulations, not in conflict with the statute, and in force through successive reenactment of the statute, have the force of law so long as they remain outstanding.

Article 113(a)(8)-1 of Regulations 94, promulgated under the Revenue Act of 1936, expressly provides that property may be received "from a shareholder as paid-in surplus, or from any person as a contribution to capital". This quoted language has been contained in the Treasury Regulations through successive reenactments of the statute continuously since 1934. Article 113(a)(8)-1 of Regu-

lations 86, 94 and 101; Section 19.113(a)(8)-1 of Regulations 103. Identical language is contained in the recently issued Excess Profits Tax Regulations 109, Section 30.718-1, and in Bulletin "F" (Revised January, 1942) of the Internal Revenue Bureau. This provision of the regulations, which doubtless stems from just such cases as *Edwards* v. *Cuba Railroad Company*, now has the force of law. Yet the Circuit Court of Appeals has ignored it and has ruled that the payments made by petitioner's prospective customers could not constitute contributions to capital since they were not made by shareholders.

4.

The Circuit Court of Appeals has decided an important Federal tax question in a way that is probably in conflict with its own prior decision in *Nashville Warehouse & Elevator Corporation* v. *Commissioner*, 105 F. (2d) 883, a case which the Court thought distinguishable but which the Circuit Court of Appeals for the Fourth Circuit in *Arundel-Brooks Concrete Corporation* v. *Commissioner* said was persuasively analogous.

In *Nashville Warehouse & Elevator Corporation* v. *Commissioner*, the taxpayer purchased elevator property for $40,000 payable in installments and paid all but $12,733.67 of the purchase price out of the proceeds of fire insurance collected upon the destruction of the property by fire. The Commissioner contended that the cost of the property to the taxpayer was $12,733.67, not $40,000. But the Court answered this by saying: "Obviously the full item should be included in figuring the cost of the property. Whatever the source of the funds from which payment was made, the cost was $40,000."

The decision of the Circuit Court of Appeals here was essentially based upon tracing the source of the moneys used by petitioner in constructing its line extensions. Petitioner argued that the funds so used were not traceable and that even if they were their source—whether from earnings, loans, capital contributions, gifts or otherwise—was wholly immaterial. But the Court rejected this argument and held that the funds constituted receipts to be deducted from actual cost of construction in determining petitioner's cost for depreciation purposes.

5.

The Circuit Court of Appeals has decided an important question of Federal tax law which has not been, but should be, settled by this Court. Money and property contributions and subsidies to corporations from third parties for specific purposes in the mutual interests of all concerned are not uncommon. The status of such contributions and subsidies as respects their taxability as income has been settled by this Court in *Edwards* v. *Cuba Railroad Company*, which has been uniformly followed in a long line of cases.

The equally important question as to the effect of such cash contributions upon the basis of the property constructed therewith, and as to the basis of property directly contributed, has not been settled. The decisions below are in conflict and confusion and, unless now settled, much further litigation seems inevitable. Not only is the present dispute with owners of such property sure to recur, but business concerns making contributions to procure construction may be expected, as indeed has recently been publicly suggested (Alexander Tax News Letters, December 11 and

18, 1942), to claim the benefit of the depreciation deductions if and to the extent denied the owner, notwithstanding that the contributor has no continuing right or interest in any particular property constructed and notwithstanding that such rights as he possesses continue indefinitely through successive renewals and replacements of the original property at the owner's expense.

The statute recognizes the fundamental principle that depreciation sustained through use of property in a business is one of the natural and ordinary expenses of doing business, and that profits cannot be determined until depreciation is taken into account. It undertakes to cover in detail the whole field of allowances for depreciation and the depreciation basis, however the property may have been acquired. Congress was concerned with the fact that it is the property itself that depreciates; and it provided for a continuity of the depreciation basis and gave a new basis only when an owner, paying a consideration, ought not to be tied to someone else's cost.

If a taxpayer owns a plant, the basis for computing depreciation on it under the statute depends upon whether it was acquired for a consideration or without a consideration. If the taxpayer built it or otherwise acquired it for a consideration, the depreciation basis is the amount or value of the consideration given for it by the taxpayer, which would be its cost; and this would be true irrespective of whether the money utilized for that purpose was derived from capital, earnings, borrowing, gifts or any other source. If the taxpayer gave no consideration and accordingly received the plant as a gift or as a contribution to capital, the depreciation basis would continue to be the same as in the hands of the transferor. The operation of the plant of neces-

sity consumes it over its useful life and hence depreciation is allowed.

Here, inescapably, the line extensions were acquired by petitioner either for a consideration or without a consideration. If acquired for a consideration, the amount or value of that consideration is petitioner's basis for depreciation under Section 113(a) of the statute. If acquired without a consideration on the theory that they were in effect contributed by the prospective customers, then the petitioner took over the latter's basis under Section 113 (a) (2) or (8) (B). Under either of these theories — alternatives covering the whole field — the result is the same: the petitioner's depreciation basis for the line extensions is what it cost to construct them.

Section 113(b)(1)(A) has no more to do with the matter, and no different effect upon such basis, than if the line extensions had been built by the prospective customers in the first instance and then turned over to the petitioner. The cash contributions, when expended for capital assets, served to increase capital account to exactly the same extent as if there had been a contribution of the property itself. In either case the basis for depreciation would be the same under the scheme of the statute.

Section 113(b)(1)(A) merely contains the expected requirement that adjustment in respect of property must be made for items "properly chargeable to capital account". This provision was clearly intended to cover subsequent capital expenditures on the property and possibly also such items as sale of part of the property, adjustment of the purchase price and items of that kind. But it would beg the question to say that this section is determinative here, for the primary questions would still be open for decision,

namely, the legal status of the funds petitioner received and the right to trace and materiality of the source of the funds used in the construction.

In view of the conflict that has developed on this subject and of its broad importance, the meaning and spirit of the statute are urgently in need of clarification by this Court.

WHEREFORE your petitioner prays that its petition be granted and that a writ of certiorari be issued to review the judgment herein of the Circuit Court of Appeals for the Sixth Circuit.

EDWARD H. GREEN,
NORRIS DARRELL,
48 Wall Street,
New York, N. Y.

OSCAR C. HULL,
HARVEY A. FISCHER,
Dime Building,
Detroit, Michigan.

Attorneys for Petitioner.

SULLIVAN & CROMWELL,
48 Wall Street,
New York, N. Y.
Of Counsel.

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